RECORD AND BRIEFS

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No. 15-1509

In the Supreme Court of the United States

U.S. BANK NATIONAL ASSOCIATION, *ET AL.*, BY AND THROUGH, CWCAPITAL ASSET MANAGEMENT LLC, SOLELY IN ITS CAPACITY AS SPECIAL SERVICER,

Petitioner,

v.

THE VILLAGE AT LAKERIDGE, LLC, ET AL,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

REPLY BRIEF FOR PETITIONER IN RESPONSE TO BRIEF OF THE UNITED STATES AS AMICUS CURIAE

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RULE 29.6 CORPORATE DISCLOSURE STATEMENT

Petitioner U.S. Bank National Association is a wholly owned subsidiary of U.S. Bancorp, a publicly held company. No publicly-held entity owns 10% or more of the stock of U.S. Bancorp.

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INTRODUCTION

The certiorari petition raises important questions regarding the proper interpretation of the Bankruptcy Code that will profoundly impact Chapter 11 bankruptcy cases and commercial transactions for years to come. The United States ignores the extraordinary policy implications resulting from the Ninth Circuit's decision, *In re The Village at Lakeridge*, 814 F.3d 993 (9th Cir. 2016) ("*Lakeridge*"), which now provides a basis for debtors to "game the system" by circumventing § 1129(a)(10)'s statutory prohibition against insider voting. The decision not only affects plan confirmation cases involving cramdown fights, but will impact the practice of claims trading and many areas of bankruptcy law that address the treatment of insiders.

At the heart of the United States' response is its mistaken belief that the Petition[1] raises factual rather than legal issues. This was the same mistake made by the Ninth Circuit. As discussed in the Petition, the material facts are undisputed, and the Petition asks the Court to resolve the following important legal issues capable of repetition: (a) whether an assignee of an insider claim acquires the claim subject to the assignor's insider status under the general law of assignment such that his vote cannot be considered to confirm a cramdown plan; (b) the proper test for determining non-statutory insider status; and (c) the proper standard of review for determining non-statutory insider status. *Lakeridge* also creates a

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[1] All capitalized terms have the meanings ascribed to them in the Petition.

circuit split regarding the appropriate test and standard of review for determining non-statutory insider status.

Numerous bankruptcy scholars have criticized *Lakeridge's* rationale and discuss the adverse consequences of the decision. Not a single published article has praised *Lakeridge* as having been correctly decided. Certiorari should be granted because of the profound policy implications of permitting insiders to wash their claims of insider status.

A. The Ninth Circuit Significantly Undermines the Bankruptcy Code's Prohibition Against Insider Voting

The United States ignores the significance of *Lakeridge* on bankruptcy law. The decision creates a legal loophole that enables debtors to subvert the Bankruptcy Code by assigning insider claims free of their insider status for the sole purpose of confirming a cramdown plan. As Judge Clifton noted:

> [T]he majority opinion effectively renders that statutory requirement meaningless.... [I]nsiders are free to evade the [Bankruptcy Code's prohibition against insider voting] simply by transferring their interest . . . to a friendly third party, who can then cast the vote the insider could not have cast itself.[2]

The United States argues without any legal authority that the general law of assignment does not preclude an assignee from voting a claim acquired from

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[2] *Lakeridge,* 814 F.3d at 1007 (J. Clifton, dissenting).

an insider under § 1129(a)(10), and that the Panel majority's "[f]ocus[ ] on the insider status of a current claimholder, rather than on the ownership history of a claim, is consistent with the logic and purposes of the relevant Code provisions." U.S. Br., at 10. This unsubstantiated reading of the statute is incorrect and renders the prohibition against insider voting meaningless.

Under general assignment law, an assignee stands in the shoes of its assignor and takes the claim subject to all of the assignor's rights and disabilities.[3] The rights and disabilities of claimholders "are fixed by the status of their claims when the petition in bankruptcy is filed."[4]As reported in the Congressional debates of 1790: "[T]he assignee stands ***precisely*** in the shoes of the assignor."[5] Common law has "long recognized that '[a]n assignment . . . provides the assignee with the ***same legal rights as the assignor had before assignment.***'"[6] A corollary to general assignment law is

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[3] *Citibank, N.A. v. TeleResources, Inc.*, 724 F.2d 266, 269 (2d Cir. 1983); *Goldie v. Cox*, 130 F.2d 695, 720 (8th Cir. 1942).

[4] *Swarts v. Siegel*, 117 F. 13, 14 (8th Cir. 1902). *See also In re Stewart Foods, Inc.*, 64 F.3d 141, 146 (4th Cir. 1995).

[5] United States Congress. The Debates and Proceedings in the Congress of the United States, *et al.* (Gales & Seaton, 1834), at 1293 (citing public debate of Feb. 17, 1790) (emphasis added).

[6] *Interim Capital LLC v. Herr Law Group, Ltd.*, 2011 WL 7047062, at *6 (D. Nev. Oct. 21, 2011) (citations omitted) (emphasis added); *Cascades Dev. of Minn.*,

the doctrine of *nemo dat qui non habet*: an assignor cannot give more than he has.[7]

The United States fails to cite any authority for the proposition that Congress intended to abrogate general assignment law when it enacted § 1129(a)(10). As the Ninth Circuit noted in a similar context involving the applicability of general assignment law to § 523(a)(2)(B), "[i]n the absence of . . . specific language, we believe that Congress intended that the general law of assignment remains applicable."[8] The same analysis applies here. The phrase, "any insider," as used in § 1129(a)(10) is not specific enough to abrogate general assignment law, but must be read in the context of claims voting. Only "[t]he holder of a claim . . . may accept or reject a plan."[9] The phrase, "any insiders," is not temporal but applies to claims held by insiders regardless of when the insider held the claim. The legislative history makes clear that "***any claims . . . held by insiders*** are not to be included for purposes of determining the number and amount of acceptances."[10] Because Rabkin's legal rights were tainted by MBP's

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LLC v. National Specialty Ins., 675 F.3d 1095, 1099 (8th Cir. 2012) (same).

[7] *Hendrie v. Sayles*, 98 U.S. 546, 550-51 (1878); *In re NobleHouse Technologies, Inc.*, 2013 WL 6816129, at *5 (Bankr. N.D.N.Y. Dec. 24, 2013) (citation omitted).

[8] *In re Boyajian*, 564 F.3d 1088, 1091 (9th Cir. 2009).

[9] 11 U.S.C. § 1126(a).

[10] See S. REP. NO. 95-989, tit. IV, ch. 11, sub-ch. II at 128 (1977) (emphasis added).

insider status, Rabkin acquired the claim subject to MBP's voting disqualification. Any other reading renders the Bankruptcy Code's prohibition against insider voting meaningless, and effectively increases the value of MBP's claim that Bartlett conceded was worthless. [11]

The United States focuses a significant portion of its analysis on the assignor's motives, concluding that "an outsider who purchases a claim from an insider would not inherit the insider's motives for voting to accept a proposed plan." *Id.* at 10-11. This is a red herring. While motives may have a bearing on whether a transaction was conducted at arm's length for purposes of determining *non-statutory insider status*, they have no bearing on whether an assignee of an insider claim acquires the *assignor's* insider status. If holders of insider claims were not disqualified from voting regardless of motive, virtually every debtor would cause an insider to manufacture and assign its claim to circumvent the prohibition against insider voting. Plan confirmation fights that turn on the vote of insider claims would virtually always become fights over whether the assignment was made in "good faith," which is an independent statutory requirement under §§ 1129(a)(3) and 1126(e). It is a mistake to impose a separate "good faith" requirement into § 1129(a)(10) as justification for ignoring the well-settled law of assignment.

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[11] Bartlett testified: "[W]e knew we couldn't vote that claim ourselves. It wasn't really worth anything to us." Tr. of H'rg on Designation Motion (Aug. 1, 2012), at 36, 42-43.

The United States' interpretation of § 1129(a)(10) also disregards the heightened scrutiny afforded insider transactions. [12] The Bankruptcy Code consistently treats the conduct of insiders and insider-transactions with close scrutiny. *See, e.g.*, §§ 503(c) (limiting insider compensation); 547(b)(4)(B) (extended preference period for insider transfers); 702(a)(3) (excluding insider voting for trustees); 727(a)(7) (establishing insider conduct as basis to deny discharge); 747(1) (subordinating insider claims to other customer claims); 1129(a)(5)(B) (requiring disclosure of insider retention). The "danger inherent in any reorganization plan proposed by a debtor . . . [is] that the plan will simply turn out to be too good a deal for the debtor's owners" at the expense of disfavored creditors. [13] The *Lakeridge* ruling undermines the Bankruptcy Code's prohibition against insider voting that was enacted to prevent the very type of artificial impairment and voting manipulation that would occur if claims could be manufactured and voted by insiders or their assignees.[14]

Several bankruptcy scholars have raised serious concerns that *Lakeridge* will be interpreted

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[12] *See Matter of Holloway*, 955 F.2d 1008, 1010-11 (5th Cir. 1992).

[13] *Bank of America Trust & Savings Ass'n v. 203 North LaSalle Street Partnership*, 526 U.S. 434, 444 (1999) (absolute priority rule protects against "the ability of a few insiders . . . to use the reorganization process to gain an unfair advantage.") (Citation omitted).

[14] *See Lakeridge*, 814 F.3d at 1007 (J. Clifton, dissenting).

expansively to enable claims purchasers to acquire claims free and clear of disabilities. As one commentator describes:

> The [*Lakeridge*] decision eliminates a bright-line rule that insiders cannot "wash" their insider status by selling claims to sympathetic third parties. As a result, insiders will be incentivized to wash their claims and then argue that the facts and circumstances of the case excuse the buyer from being deemed a "statutory insider." . . . [T]he . . . decision opens the door for claims buyers to argue that other debtor payment defenses (similar to insider status) are not part of a claim's attributes, and therefore, the claim can be transferred free and clear of such defenses.[15]

Another scholar criticized *Lakeridge* for permitting claimants to wash their claims of disabilities by enabling assignees to acquire insider claims "free of the defenses that would have applied to the insider, even though the transferee is fully aware of those defenses and infirmities," and for granting assignees greater rights than those held by their assignors.[16] Thus, while

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[15] Bruce S. Nathan, *et al.*, *Last in Line: Purchasing Claims Free and Clear of a Debtor's Defenses, The Conflicting Views of the Third and Ninth Circuits*, AM. BANKR. INST. J., Oct. 2016, at 32.

[16] *Third Party Creditor Holding Claim Originally Owned by Debtor's Parent Entity May Vote for Cramdown Plan, Even Though Claim Was Purchased for Far Less than Full Value and Creditor Had Close*

the United States may not appreciate the impact *Lakeridge* will have in plan confirmation litigation, numerous bankruptcy scholars recognize the controversial nature of the decision and its impact on bankruptcy practice.[17]

The paradigm created by *Lakeridge* is particularly problematic for commercial real estate lenders, which base their financing structures on collateral isolation through single purpose entities to avoid artificially concocted cramdown plans. If this decision stands, it will be virtually impossible to create an ownership and operational structure that prevents artificial impairment and the resulting cramdown risk. The new realty will be reflected in higher financing costs and less available credit.

B. The Ninth Circuit Decision Creates a Circuit Split Regarding the Standard of Review for Determining Non-Statutory Insider Status

The United States incorrectly states that no circuit split exists on the appropriate standard of review for determining non-statutory insider status where the material facts are undisputed. The Ninth Circuit panel majority (the "Panel majority") applied a clearly erroneous standard of review whereas the Third, Fifth, Seventh, and Tenth Circuits apply a *de novo* standard

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Personal Relationship with Member of Parent's Board of Directors, COMM. FIN. NEWS, Feb. 22, 2016, at 2 (citing *In re KB Toys, Inc.*, 736 F.3d 247, 252 (3d Cir. 2013)).

[17] *See* Petition, at 10-11 (citing articles).

of review. [18] The United States concedes that *Lakeridge's* language is "imprecise," and "appears to elide the separate factual and legal components of the bankruptcy court's ultimate conclusion as to Rabkin's insider status." U.S. Br., at 14. However, the United States points to a footnote in which the Panel majority stated that it reviewed *de novo* the bankruptcy court's definition of non-statutory insider status, and "analyze[d] whether the facts of this case are such that Rabkin met that definition, which is a purely factual inquiry and properly left to clear error review." U.S. Br., at 14 (citing App. A, 15a n. 13). This is misleading because the Bankruptcy Court never articulated a test for determining non-statutory insider status, and the material facts in this case are undisputed. Therefore, the Panel majority's application of the facts to the law presented a legal question – or at least a mixed question of law and fact.

The Ninth Circuit's standard of review is inconsistent with the standard of review applied by other circuits. In the context of a case like this one, where the facts are not disputed, the Third and Tenth Circuits apply a *de novo* standard of review of the trial court's "'interpretation and application of those facts to legal precepts.'" [19] The United States attempts to

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[18] *Compare Lakeridge*, 814 F.3d 993, App. A, at 8a, *with In re Winstar Comm'ns., Inc.*, 554 F.3d 382, 395 (3d Cir. 2009); *In re Longview Aluminum, L.L.C.*, 657 F.3d 507, 509 (7th Cir. 2011); *In re Krehl*, 86 F.3d 737, 742 (7th Cir. 1996); *In re U.S. Med., Inc.*, 531 F.3d 1272, 1275 (10th Cir. 2008).

[19] *Winstar*, 554 F.3d at 395 (quoting *CellNet Data*, 327 F.3d at 244); *see also U.S. Medical*, 531 F.3d at 175 (When "the facts are undisputed and the issue

explain away the Panel majority's error by suggesting that it did not mean what it said; that even if it "misstated the legal principles that govern appellate review . . ., the salient point is that the court of appeals understood the bankruptcy court to have found that an arm's length sale occurred...." U.S. Br., at 15. This assertion blatantly ignores what the Panel majority actually did: rubber stamp the Bankruptcy Court's legal determination of non-statutory insider status based on clear error review. The Panel majority did not independently review the undisputed facts to determine whether the Bankruptcy Court correctly interpreted and applied those facts to the law.[20] Indeed, the Panel majority suggested that its conclusion might be different had it weighed the evidence differently.[21] The majority of circuits that have considered the issue have applied a *de novo* standard of review to determinations of non-statutory insider status on the basis of undisputed facts.

This circuit split will have far reaching effect not only for future plan confirmation fights, but in many areas of bankruptcy and fraudulent conveyance law that hinge upon a determination of insider status because it effectively abdicates to the bankruptcy court sole responsibility for deciding mixed questions of law

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revolves around the legal conclusion drawn from the facts against the backdrop of a statute . . ., we have a mixed question of law and fact where the legal analysis predominates.... Our review is therefore de novo.") (Citation omitted).

[20] *See* Petition, at 6.

[21] *Id.* at 1003.

and fact. The consequences of upholding a clearly erroneous standard of review will result in widely divergent applications of the Bankruptcy Code among the nation's bankruptcy courts without any opportunity for meaningful appellate oversight.

C. The Ninth Circuit's Functional Equivalence Test for Determining Non-Statutory Insider Status Creates a Circuit Split

Finally, the United States ignores that the Ninth Circuit invented an entirely new test for determining non-statutory insider status which now requires the relationship to be "***comparable to that of the enumerated insider classifications in § 101(31)***."[22] This new language is not found in any other circuit court decision.[23]

While acknowledging the Ninth Circuit's newly-added language, the United States asserts that the Ninth Circuit actually looked at "whether the creditor shared a 'sufficiently close relationship with the debtor that [the creditor's] conduct is made subject to closer scrutiny than those dealing at arms [sic] length with the debtor." U.S. Br., at 17-18. The United States is wrong. The Ninth Circuit expressly applied a functional equivalence test when it held that Petitioner failed to show that "Rabkin's relationship with Bartlett

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[22] App. A, 13a (emphasis added).

[23] The Ninth Circuit erroneously cites *Winstar* for the proposition that "[n]on statutory insiders are the functional equivalent of statutory insiders . . . ." App. A, 13a (citing Winstar, 554 F.3d at 395). But the Third Circuit rejected this argument. *See Winstar*, at 396-97.

. . . is sufficiently close ***to compare with any category listed in § 101(31).***"[24] The Ninth Circuit gave deference to the Bankruptcy Court's consideration of just a few select factors for determining non-statutory insider status: control; separation of finances; cohabitation; and conducting business separately.[25] No circuit court has applied only these select factors for determining what constitutes an arm's length transaction.

The United States mistakenly conflates the arm's length test with bad faith. It asserts that Rabkin's non-statutory insider status "turns on the motivation for Rabkin's acquisition of MBP's claim," and suggests that the Bankruptcy Court's finding that the "insider claim was not assigned to Dr. Rabkin in bad faith . . ." should be "properly understood as an ***implicit determination*** that the sale was made at arm's length." U.S. Br., at 15, 19 (emphasis added). There is nothing in § 101(31) or any other provision of the Bankruptcy Code that suggests that the absence of bad faith alone satisfies the arm's length test. An "arm's length" transaction is:

> "1. A transaction between two unrelated and affiliated parties. 2. A transaction between two parties, however closely related they may be, conducted as if the parties were strangers, so that no conflict of interest arises."[26]

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[24] App. A, 16a (emphasis added).

[25] *Id.* at 16a-17a.

[26] *Id.* at 13a-14a, n.11.

As Judge Clifton noted, "Rabkin and Bartlett were not 'unrelated and affiliated parties' . . . [and] [t]he transaction was not an arm's length transaction."[27] The Bankruptcy Court never made a finding that Bartlett and Rabkin negotiated the assignment as if they were strangers such that no conflict of interest arose. The Bankruptcy Court's analysis of whether a claim should be designated under § 1126(e) if the creditor's vote is accepted, solicited or procured in bad faith, is an entirely different analysis from whether the transaction at issue was conducted at arm's length.

No other circuit has applied a functional equivalence test to non-statutory insider determinations. *Lakeridge* creates a circuit split that should be resolved by this Court.

CONCLUSION

For the foregoing reasons, certiorari should be granted.

Respectfully submitted,

Dated: March 1, 2017

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[27] *Id.*